

**Significant Tax Revenue May Be Lost Due to  
Inaccurate Reporting of Taxpayer  
Identification Numbers for Independent  
Contractors**

**August 2001**

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**This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.**



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

August 24, 2001

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-  
EMPLOYED DIVISION

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner  
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Significant Tax Revenue May Be Lost Due  
to Inaccurate Reporting of Taxpayer Identification Numbers for  
Independent Contractors

This report presents the results of our review of the Internal Revenue Service's (IRS) ability to encourage the filing of accurate information returns for non-employee compensation through its administration of the existing backup withholding and penalty provisions. We performed this review because combating important areas of noncompliance is one of the IRS' strategies for achieving its goal of providing service to all taxpayers through the fair and uniform application of the law.

In summary, from Tax Years (TY) 1995 through 1998, the IRS received about 9.6 million information documents, reporting approximately \$204 billion in non-employee compensation, that did not contain a Taxpayer Identification Number (TIN) or match the IRS' records of assigned TINs. Consequently, the IRS could not use these documents to verify that the taxpayers had filed tax returns and reported this income. The current tax laws and regulations enable the IRS to impose backup withholding requirements and assert civil penalties on payers, when applicable, to encourage the submission of accurate information returns. However, these tools have been used sparingly and have been largely ineffective as evidenced by a 36 percent increase in the number of information documents received with missing or invalid TINs between 1995 and 1998. Tax law changes are needed to effect significant improvement in information reporting and to protect the substantial tax revenues that are potentially being lost each year.

Management's Response: In response to our recommendations, IRS management agreed to consider the feasibility of proposing new legislation to require mandatory withholding of income taxes on non-employee compensation payments, supplementing the Internet-based TIN confirmation program with an automated telephone-based system, and proposing legislation to change the criteria for asserting the Incorrect Information Penalty.

However, IRS management did not agree with proposing legislation to make it mandatory for payers to verify the accuracy of TINs at the beginning of their relationship with a payee. They also did not agree with changing the IRS' administrative guidelines so that when the results of any submission to the TIN verification program indicate that a TIN is invalid, it constitutes the IRS' official notice to the payer to begin imposing backup withholding if the recipient does not provide a correct TIN.

Office of Audit Comment: We are encouraged that the IRS plans to consider some of our recommendations. However, we are disappointed that the IRS' response does not reflect a stronger overall commitment for seeking legislation that would help to address a significant tax compliance problem involving a rapidly growing segment of taxpayers. We are particularly concerned that the IRS does not plan to enforce accurate TIN reporting once a TIN verification program is made available to payers. If the IRS does not require accurate TIN information from payers, compliance is not likely to improve. While we still believe our recommendations are worthwhile, we do not intend to elevate the disagreement concerning them to the Department of the Treasury for resolution.

We have included both the IRS' response and our comments concerning the response in the main body of this report. The full text of management's response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

**Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer  
Identification Numbers for Independent Contractors**

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**Table of Contents**

Executive Summary.....	Page i
Objective and Scope.....	Page 1
Background .....	Page 2
Results .....	Page 3
A Tax Law Change to Require Withholding on Non-Employee Compensation Would Encourage Independent Contractors to Furnish Correct Taxpayer Identification Numbers .....	Page 4
Backup Withholding Laws and Penalty Provisions Need Strengthening to Improve Compliance with Information Reporting Requirements .....	Page 9
Conclusion.....	Page 16
Appendix I – Detailed Objective, Scope, and Methodology .....	Page 17
Appendix II – Major Contributors to This Report.....	Page 19
Appendix III – Report Distribution List.....	Page 20
Appendix IV – Outcome Measures.....	Page 21
Appendix V – Management’s Response to the Draft Report .....	Page 22

# **Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors**

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## **Executive Summary**

For Tax Years (TY) 1995 through 1998, the Internal Revenue Service (IRS) received about 9.6 million Statements for Recipients of Miscellaneous Income (Forms 1099-MISC),<sup>1</sup> reporting approximately \$204 billion in non-employee compensation, that did not contain a Taxpayer Identification Number (TIN) for the payee or match the IRS' records of assigned TINs.<sup>2</sup> Consequently, the IRS could not use these information documents in its computer-matching programs to determine whether the recipients of this compensation filed a tax return and/or reported all of the income.

Under the Internal Revenue Code (I.R.C.),<sup>3</sup> payers are required to immediately begin backup withholding of taxes, at a rate of 31 percent, from non-employee compensation payments if the recipients fail to furnish a TIN. Payers are also required to begin backup withholding if the payees fail to timely resolve an incorrect TIN condition after the IRS has notified them.<sup>4</sup> Treasury Regulation § 301.6721-1 also permits the IRS to impose a \$50 civil penalty upon payers for each information return that fails to include all required information or includes incorrect information.

Combating important areas of noncompliance is one of the IRS' strategies for achieving its goal of providing service to all taxpayers through the fair and uniform application of the law. The objective of this audit was to determine whether opportunities exist for the IRS to increase payer compliance with the reporting requirements for non-employee compensation by more effectively administering the existing tax laws and regulations.

## **Results**

The IRS' ability to encourage the filing of accurate information returns for non-employee compensation, through its administration of the existing backup withholding and penalty provisions, is extremely limited and largely ineffective. Between TYs 1995 and 1998,

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<sup>1</sup> All references to Form 1099-MISC throughout this report are to the reporting of non-employee compensation, although this form is also used to report other types of income to the IRS.

<sup>2</sup> The total number of documents and total non-employee compensation amount are based upon our analysis of electronic records extracted from the IRS' Information Returns Masterfile. We did not have access to original documents to test the reliability of the data contained in this file.

<sup>3</sup> 26 U.S.C. § 3406 (2000).

<sup>4</sup> A TIN is generally considered "invalid" when there is none present on the information document; the submitted TIN has less than nine digits; or the name/TIN combination does not match the records of the IRS or the Social Security Administration.

## **Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors**

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the number of Forms 1099-MISC reporting non-employee compensation received by the IRS with missing or incorrect TINs increased by 36 percent. Because the IRS was unable to match these documents with tax returns, tax revenue was potentially lost each year. The amount of the potentially lost revenue may be significant since the IRS' data suggests that independent contractors who receive non-employee compensation are far less compliant than wage earners in reporting their income.

This report discusses these issues and presents two divergent approaches the IRS could pursue for achieving more accurate information reporting and for protecting the significant tax revenue that may be lost due to the inaccurate reporting of TINs for independent contractors.

### **A Tax Law Change to Require Withholding on Non-Employee Compensation Would Encourage Independent Contractors to Furnish Correct Taxpayer Identification Numbers**

Each year, the IRS receives an average of 2.4 million Forms 1099-MISC reporting non-employee compensation payments totaling \$51 billion, which contain a missing or incorrect TIN.<sup>5</sup> We believe the root cause of this problem is that when a business classifies a worker as an independent contractor, the law does not require the business to withhold taxes from their compensation. Thus, by not furnishing a correct TIN, or any TIN at all, to the businesses for which they work, independent contractors can conceivably avoid paying taxes on their earnings, since the IRS will be unable to verify their compliance in reporting the income.

The fundamental solution to more accurate information reporting lies in changing the law to require mandatory income tax withholding on non-employee compensation payments. Mandatory withholding on non-employee compensation would encourage independent contractors to provide payers with an accurate TIN and provide an incentive for them to report the income on their tax returns. It would also enable the IRS to more fairly administer its tax compliance programs among both employees and independent contractors, and reduce the need for the IRS to burden businesses with backup withholding notices and penalties that have proven to be largely ineffective.

In the past, the General Accounting Office (GAO) and the Joint Committee on Taxation have both concluded that the noncompliance among independent contractors is serious enough to warrant some form of tax withholding. In a 1992 audit report,<sup>6</sup> for example, the GAO cited an IRS estimate that the annual tax gap caused by self-employed

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<sup>5</sup> Averages are based on IRS' data for TYs 1995 through 1998.

<sup>6</sup> *Tax Administration: Approaches for Improving Independent Contractor Compliance* (GGD-92-108, dated July 1992).

## **Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors**

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individuals (including independent contractors) who did not report all of their income was \$20.3 billion. In testimony<sup>7</sup> before the Congress in 1996, the GAO cited an estimate from a 1979 IRS study that 47 percent of the independent contractors reported none of their business income.

### **Backup Withholding Laws and Penalty Provisions Need Strengthening to Improve Compliance with Information Reporting Requirements**

The IRS has no effective means to ensure that payers immediately initiate backup withholding, as required by law, when independent contractors fail to provide them with a TIN. For TY 1998, the IRS received nearly 417,000 Forms 1099-MISC reporting more than \$7.2 billion in non-employee compensation, which did not include the payee's TIN. None of the 192,000 payers who submitted these information documents to the IRS had implemented backup withholding as required by law. As a result, approximately \$2.2 billion in taxes was not withheld and remitted to the IRS. It is not known how much in taxes the IRS eventually collected on this income.

In addition, almost half of all payers that submit Forms 1099-MISC with invalid TINs do not receive backup withholding notices because of the IRS' administrative criteria for issuing the notices. Because of the length of time it takes the IRS to process the information returns and identify those which contain an invalid TIN, the remaining payers who meet the IRS' backup withholding notice criteria receive the notices far too late to enable them to effectively correct most invalid TIN problems.

Penalties are also having a negligible impact on encouraging the accurate reporting of TINs on information returns. The IRS' administrative criteria for proposing penalties exclude most of the payers who submit information returns with missing or invalid TINs. For TYs 1996 and 1997, penalties were assessed against only 3,356 (0.2 percent) of the 1,643,000 payers who submitted Forms 1099-MISC with missing or invalid TINs.

### **Summary of Recommendations**

Legislation to require mandatory tax withholding on all non-employee compensation payments is needed to encourage accurate information reporting and to protect the Treasury from the potential loss of significant tax revenue. As an alternative, the IRS needs to seek changes that will enable it to more aggressively impose backup withholding requirements and civil penalties on payers who submit Forms 1099-MISC with missing or invalid TINs. A prerequisite for improving compliance with the information reporting

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<sup>7</sup> *Tax Administration: Issues in Classifying Workers as Employees or Independent Contractors* (GAO/T-GGD-96-130, dated June 20, 1996).

## **Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors**

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laws is the availability of a system that payers can use to confirm the accuracy of a TIN at the beginning of their relationship with a new worker. The IRS is currently developing an Internet-based TIN confirmation program as part of its overall business systems modernization efforts. With some changes to the tax laws and IRS procedures, we believe that the availability of a TIN verification system can also provide an opportunity to expedite and strengthen the backup withholding notification process and protect the government from the loss of tax revenue. The penalty criteria should be revised to enable the IRS to assess payers for the amount of any backup withholding they fail to collect when required by law.

Management's Response: The Commissioner, Small Business/Self-Employed (SB/SE) Division, responded that the IRS has previously submitted proposals for legislative changes to Treasury that would require mandatory withholding of income taxes on non-employee compensation payments. In the past, Treasury has chosen not to forward these proposals to the Congress. He will work with the Legislative Affairs Office to consider whether it is feasible for the IRS to submit additional proposed legislative changes.

The Commissioner, SB/SE Division, also responded that he will consider supplementing the Internet-based TIN confirmation program with an automated telephone-based TIN confirmation process. However, he did not agree with proposing legislation to make it mandatory for payers to verify the accuracy of TINs at the beginning of their relationship with a payee. He also did not agree with changing the IRS' administrative guidelines so that, when the results of any submission to the TIN verification program indicate that a TIN is invalid, it constitutes the IRS' official notice to the payer to begin imposing backup withholding if the recipient does not provide a correct TIN. The Commissioner, SB/SE Division, will, however, consider proposing legislation to change the criteria for asserting the Incorrect Information Penalty.

Office of Audit Comment: We are encouraged that the IRS plans to consider some of our recommendations. However, we are disappointed that the IRS' response does not reflect a stronger overall commitment for addressing a significant tax compliance problem involving a rapidly growing segment of taxpayers. We are particularly concerned that the IRS does not plan to enforce accurate TIN reporting once a TIN verification program is made available to payers. If the IRS does not require accurate TIN information from payers, compliance is not likely to improve.

We have included both the IRS' response and our comments concerning the response in the main body of this report. The full text of management's response to the draft report is included as Appendix V.



# Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors

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## Objective and Scope

*We performed this review to determine whether the IRS has opportunities to improve compliance with the information reporting laws for non-employee compensation.*

Our overall objective was to determine whether opportunities exist for the Internal Revenue Service (IRS) to increase payer compliance with the information return filing/reporting requirements for non-employee compensation by more effectively applying the existing tax laws and regulations. Our purpose in conducting the review was to assist the IRS in its strategy to combat important areas of noncompliance to achieve its goal of providing service to all taxpayers through the fair and uniform application of the law.

To accomplish this objective, we determined whether the IRS effectively monitored and enforced payer compliance with the Internal Revenue Code (I.R.C.) backup withholding provisions for income recipients who fail to furnish a correct Taxpayer Identification Number (TIN).<sup>1</sup> We also evaluated whether the IRS' application of civil penalties against payers who submitted information documents with missing or incorrect TINs was consistent with its Penalty Policy Statement.

We focused our analysis on the invalid TIN<sup>2</sup> data received by the IRS on Statement for Recipients of Miscellaneous Income (Form 1099-MISC)<sup>3</sup> reporting non-employee compensation. To accomplish our objective, we extensively relied on computer-processed data extracted from the IRS' Information Returns Masterfile (IRMF). We did not establish the reliability of this data because the majority of the input to this file

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<sup>1</sup> 26 U.S.C. § 3406 (2000).

<sup>2</sup> A TIN is generally considered "invalid" when there is none present on the information document; the submitted TIN has less than nine digits; or the name/TIN combination does not match the records of the IRS or the Social Security Administration.

<sup>3</sup> All references to Form 1099-MISC throughout this report are to the reporting of non-employee compensation, although this form is also used to report other types of income to the IRS.

## Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors

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originated from magnetic media sources outside of the IRS. This report reflects the actual number of deficiencies identified rather than sampled results. We also reviewed program requirements for the Backup Withholding-Incorrect TIN and the Incorrect Information Penalty programs.

Except for validating the accuracy and completeness of the IRMF data,<sup>4</sup> this review was conducted in accordance with *Government Auditing Standards*. Our fieldwork was performed between June 2000 and February 2001 in the IRS' Headquarters Office.

Details of our objective, scope, and methodology are presented in Appendix I. A listing of major contributors to this report is shown in Appendix II.

### Background

Federal tax laws<sup>5</sup> require all entities engaged in a trade or business to file an accurate statement of payments made for services performed by each recipient. The IRS has prescribed the use of Form 1099-MISC for reporting payments of \$600 or more on a calendar-year basis to persons who are not employees (e.g., independent contractors).

*The IRS uses the information documents it receives to ensure compliance with the tax laws.*

The IRS uses these information documents in its computer-matching program to determine whether the income recipients filed a return and/or reported all of their income. First, however, the IRS must validate the accuracy of the payee's name and TIN. The validation program compares the information return data to the IRS' and the Social Security Administration's (SSA) records of valid TINs and associated taxpayer names. For individuals, the TIN is generally the Social Security

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<sup>4</sup> The accuracy of much of the information presented throughout this report is dependent upon the accuracy and completeness of the IRS data files we analyzed.

<sup>5</sup> 26 U.S.C. § 6041(a) (2000).

## Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors

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*The IRS can impose backup withholding and civil penalties to encourage compliance with information return reporting requirements.*

Number (SSN) assigned by the SSA, while for businesses, the TIN is generally the Employer Identification Number (EIN) assigned by the IRS. For sole proprietors, the TIN may be an SSN or EIN.

The tax laws and regulations currently provide the IRS with two tools to encourage the filing of information returns with accurate TINs. For example, the law<sup>6</sup> requires payers to immediately begin the backup withholding of taxes, at a rate of 31 percent, from certain reportable payments (including non-employee compensation) if the recipient fails to furnish a TIN. Payers are also required to commence backup withholding if the payees fail to timely resolve an incorrect TIN condition after the IRS has notified them that the TIN is incorrect. Treasury Regulation § 301.6721-1 permits the IRS to impose a \$50 civil penalty upon payers for each information return that fails to include all required information or includes incorrect information.

### Results

*The IRS has been unsuccessful at achieving compliance with information reporting laws. There has been a 36 percent increase in the number of information returns reporting non-employee compensation that contained missing or incorrect TINs between TYs 1995 and 1998.*

The IRS' ability to encourage the filing of accurate information returns for non-employee compensation, through its administration of the existing backup withholding and penalty provisions, is extremely limited and largely ineffective. Between Tax Years (TY) 1995 and 1998, the number of Forms 1099-MISC submitted to the IRS with missing or incorrect TINs increased by 36 percent.<sup>7</sup> As a result, there was a potential loss of significant tax revenues, since the IRS was unable to verify that more than \$200 billion in non-employee compensation was reported on tax returns filed for these years.

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<sup>6</sup> 26 U.S.C. § 3406 (2000).

<sup>7</sup> The number of Forms 1099-MISC with missing or incorrect TINs increased from 2,001,804 in TY 1995 to 2,720,473 in TY 1998.

## **Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors**

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This report explores these issues and presents two different approaches that the IRS could take to achieve more accurate information reporting for non-employee compensation. Both approaches would require changes to the existing tax laws. The first would require businesses to withhold taxes from payments made to independent contractors. The second would use the IRS' planned Internet application for payers to verify TINs as a means to expedite the backup withholding notification process and, when applicable, to permit the IRS to assess the businesses for the amount of any backup withholding that they failed to collect.

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### **A Tax Law Change to Require Withholding on Non-Employee Compensation Would Encourage Independent Contractors to Furnish Correct Taxpayer Identification Numbers**

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*The IRS was unable to verify that more than \$200 billion in non-employee compensation was reported on tax returns filed for TYs 1995 through 1998.*

For each tax year from 1995 to 1998, the IRS received an average of 2.4 million Forms 1099-MISC, reporting non-employee compensation payments totaling \$51 billion, that did not contain valid TINs for the payees.<sup>8</sup> Consequently, the IRS could not use these information documents in its computer-matching program to determine whether the income recipients filed a return and/or reported all of their income.<sup>9</sup> Thus, by not furnishing a correct TIN, or any TIN at all, to the businesses for which they work, independent contractors can conceivably avoid paying taxes on their earnings, since the IRS will be unable to verify their compliance in reporting the income. The eventual payment and/or collection of taxes on this income is at risk because,

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<sup>8</sup> Averages are based upon our analysis of electronic records extracted from the IRS' IRMF. We did not have access to original documents to test the reliability of the data contained in this file.

<sup>9</sup> We did not determine the scope of actual underreporting due to the labor-intensive manual research that would have been required to identify invalid conditions resulting from payer and/or IRS input errors.

## Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors

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historically, tax compliance among independent contractors who earn non-employee compensation has been significantly lower than wage earners whose taxes are withheld by their employers.

When a business classifies<sup>10</sup> a worker as an employee, the business must withhold income taxes and Social Security/Medicare contributions from the worker's pay and send the withheld taxes to the IRS. Withholding is a fundamental premise of the voluntary compliance system for individual employees in that it provides for a gradual and systematic method to pay taxes and, assuming that they provide a correct TIN, it ensures that the employees receive credit for Social Security coverage. For example, an audit report by the General Accounting Office (GAO) cited a 1988 study by the IRS that showed employees subject to withholding had voluntarily reported 99.5 percent of their 1987 wage income.<sup>11</sup>

We believe that the root cause of the significant information reporting problems for non-employee compensation is that when a business classifies workers as independent contractors, the business is not required to withhold taxes, as it would be if these workers were classified as employees. Instead, self-employed taxpayers, such as independent contractors, are required to make estimated tax payments in quarterly installments. In addition to income taxes, these estimated payments include contributions to the Social Security trust fund.

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<sup>10</sup> The IRS has adopted 20 common law rules for classifying workers. The degree of control that a business has over a worker largely determines whether the worker should be classified as an employee or independent contractor.

<sup>11</sup> *Tax Administration: Approaches for Improving Independent Contractor Compliance* (GGD-92-108, dated July 1992).

## Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors

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*The number of self-employed taxpayers is increasing at almost twice the rate of wage earners.*

To reduce costs, businesses are increasingly outsourcing work because they do not have to pay payroll taxes on payments to independent contractors and include independent contractors in their retirement plans and other fringe benefits. A recent financial magazine article<sup>12</sup> stated that the number of self-employed taxpayers rose 26 percent between 1988 and 1999, while the number of taxpayers reporting wage income<sup>13</sup> grew by only 14 percent.

Not withholding income tax on independent contractors has a significant effect on voluntary compliance. For example, the IRS' Statistics of Income (SOI) data for individual income tax returns filed during 1997 showed that 2.3 million (26 percent) of the 8.8 million unpaid balance due returns involved taxpayers who had no withholding.

*The GAO has been a proponent of expanding withholding to include more nonwage sources of income.*

As early as 1979, the GAO concluded that the noncompliance among independent contractors was serious enough to warrant some form of tax withholding on payments made to them.<sup>14</sup> Since then, at least two GAO reports and congressional testimonies<sup>15</sup> have suggested withholding taxes from payments to independent contractors.

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<sup>12</sup> Janet Novack, "Are You a Chump?", *Forbes* 167 (March 5, 2001): 122-129.

<sup>13</sup> Wage earners are typically employees whose income taxes and Social Security contributions are withheld by their employers. Self-employed individuals, such as independent contractors, are required to make estimated tax payments to the IRS in quarterly installments.

<sup>14</sup> Hearing on Compliance Problems of Independent Contractors before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, July 17, 1979.

<sup>15</sup> These reports and testimonies include: *Tax Administration: Approaches for Improving Independent Contractor Compliance* (GGD-92-108, dated July 1992); *Tax Administration: Issues Involving Worker Classification* (GAO/T-GGD-95-224, dated August 2, 1995); *Tax Administration: Issues in Classifying Workers as Employees or Independent Contractors* (GAO/T-GGD-96-130, dated June 20, 1996); and *Tax Administration: Tax Compliance of Nonwage Earners* (GAO/GGD-96-165, dated August 1996).

## Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors

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To support this position, the GAO has cited various IRS studies and data that show a significantly lower level of compliance among independent contractors as compared to employees.

- An IRS study for TY 1974 showed that independent contractors voluntarily reported only 74 percent of their income.
- A 1979 IRS study estimated that 47 percent of the independent contractors reported none of their business income.
- The IRS' estimate of the 1992 tax gap caused by self-employed individuals (including independent contractors) who did not report all of their income was \$20.3 billion.
- About \$58.5 billion (74 percent) of the \$79.2 billion in taxes owed the IRS at the end of Fiscal Year (FY) 1993 was owed by taxpayers with primarily nonwage income.

*The Joint Committee on Taxation has also suggested mandatory withholding as a way to improve tax compliance among independent contractors.*

In addition, a 1992 report<sup>16</sup> by the Joint Committee on Taxation acknowledged the revenue loss associated with the lower compliance rates of independent contractors and made suggestions to improve compliance and enforcement. One suggestion was to require businesses to withhold income and employment taxes from payments to independent contractors, just as such taxes are withheld from wages paid to employees.

The fundamental solution to more accurate information reporting lies in changing the law to require mandatory income tax withholding on non-employee compensation payments. Mandatory withholding on non-employee compensation would encourage independent contractors to provide payers with an accurate TIN and provide an incentive for them to report the income on their tax returns. It would also enable the IRS to more fairly

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<sup>16</sup> *Present Law and Issues Relating to Misclassification of Employees and Independent Contractors for Federal Tax Purposes* (JCX-27-92, dated July 22, 1992).

## **Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors**

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administer its tax compliance programs among both employees and independent contractors, and reduce the need for the IRS to burden businesses with backup withholding notices and penalties that have proven to be largely ineffective.

### **Recommendation**

The Director, Compliance, Small Business/Self-Employed (SB/SE) Division, is responsible for the overall management of programs that address post-filing compliance issues involving non-employee compensation. To reduce the number of information documents received each year with missing or invalid name/TIN data and to promote increased tax compliance by independent contractors, the Director, Compliance, needs to:

1. Initiate a proposal for the IRS Commissioner to submit to Treasury recommending changes to the tax law to require the mandatory withholding of income taxes on non-employee compensation payments.

Management's Response: The Commissioner, SB/SE Division, responded that the IRS has previously submitted proposals for legislative changes to Treasury that would require mandatory withholding of income taxes on non-employee compensation payments. In the past, Treasury has chosen not to forward these proposals to the Congress. He will work with the Legislative Affairs Office to consider the likelihood of Treasury's acceptance of a resubmitted proposed legislative change and, by December 31, 2001, decide whether it is feasible for the IRS to submit it.

Office of Audit Comment: While we are encouraged that the IRS plans to consider our recommendation, we are disappointed that the IRS' response does not reflect a stronger overall commitment for seeking legislation that would help to address a significant tax compliance problem involving a rapidly growing segment of taxpayers.



## Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors

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### **Backup Withholding Laws and Penalty Provisions Need Strengthening to Improve Compliance with Information Reporting Requirements**

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For a variety of reasons, the IRS has not been able to effectively use backup withholding and civil penalties as tools to encourage compliance with information reporting requirements for non-employee compensation. Consequently, as previously stated, between TYs 1995 and 1998, the number of Forms 1099-MISC submitted to the IRS with missing or incorrect TINs increased by 36 percent.

#### **The current backup withholding laws are not effectively promoting compliance with information reporting requirements for independent contractors**

I.R.C. § 3406 requires payers to immediately begin backup withholding at a rate of 31 percent from certain reportable payments (including non-employee compensation) if the recipient fails to furnish a TIN. The Senate Finance Report<sup>17</sup> supporting the legislation that first imposed backup withholding on payments to independent contractors stated:

*The absence of a correct TIN on an information return often makes it difficult and expensive for the Internal Revenue Service to match and verify the proper reporting of income on the tax return of the taxpayer concerned. The committee believes that if a taxpayer fails to supply his correct TIN to another person withholding should be imposed to assure that taxpayers comply with the income tax laws.*

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<sup>17</sup> S. Rept. No. 97-494, 97th Cong. 2d Sess. Vol. 1 (1982).

## Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors

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*Businesses are not imposing backup withholding when independent contractors fail to furnish a TIN.*

The IRS received nearly 417,000 Forms 1099-MISC for TY 1998 that did not include the payee's TIN. These documents reported more than \$7.2 billion in non-employee compensation. However, none of the 192,000 payers who filed these information returns had imposed backup withholding as required by law. As a result, the IRS did not receive approximately \$2.2 billion in withheld income taxes. It is not known how much in taxes the IRS eventually collected on this income. However, the IRS' past compliance studies suggest that a significant amount of the taxes due on the \$7.2 billion in non-employee compensation may never be paid.

*Many businesses that file information returns with missing or incorrect TINs do not receive backup withholding notices from the IRS.*

I.R.C. § 3406 also requires payers to begin backup withholding if the payees fail to timely resolve an incorrect TIN condition after the IRS has notified them that the TIN is incorrect. However, the IRS' administrative criteria<sup>18</sup> for issuing backup withholding notices excludes almost half of the businesses that file information returns with missing or invalid TINs.

Of the nearly 862,000 payers that submitted approximately 2.7 million TY 1998 Forms 1099-MISC with missing or invalid TINs, 842,177 had a distinct payer TIN and paid at least \$600 to a worker. However, 386,499 (46 percent) of these payers did not meet the IRS' backup withholding notification criteria.

*Most backup withholding notices that are issued are too late to enable correction of most invalid TINs.*

In addition, the remaining payers who did meet the IRS' backup withholding notification criteria received the notices too late to enable them to effectively correct most invalid TIN problems. Although payers are required to file information returns with the IRS by February 28 of the year following the end of the tax year, the IRS does not generate the initial backup withholding notices until October (e.g., October 1999 for TY 1998 information returns). This interval reflects the time it takes the IRS to process the information returns and validate the name and TIN data against its own records. The IRS makes a second execution of the

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<sup>18</sup> The IRS establishes administrative criteria to focus its available resources on the most productive workload.

## Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors

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*Most employer/independent contractor relationships are short-term in nature.*

backup withholding notice program in March of the subsequent tax year (e.g., March 2000 for TY 1998 information returns) to include those payers who filed their information returns late.

Therefore, by the time that the IRS issues backup withholding notices, the relationship between most payers and the recipients of the non-employee compensation has terminated. Of the 801,263 payers who submitted Forms 1099-MISC for TY 1996 with invalid TINs, 441,399 potentially met the IRS' criteria for issuing backup withholding notices. However, only 113,815 (26 percent) of these payers had retained some of the same workers in 1997. By 1998, just 51,257 (12 percent) of these payers had retained some of the same workers.

### **The future availability of a TIN verification system provides an opportunity to expedite and strengthen the backup withholding notification process**

If legislation is not enacted to require the mandatory withholding of taxes on non-employee compensation (as recommended on page 8 of this report), then other changes to the backup withholding laws and penalty provisions are needed. These changes are needed to minimize the potential loss of tax revenue and enable the IRS to more effectively encourage compliance with the information reporting requirements.

A prerequisite to improving payer compliance with information reporting requirements is the availability of a system that payers can use to verify the accuracy of a TIN at the beginning of their relationship with an independent contractor. The SSA already offers an Enumeration Verification Service (EVS) for employers that wish to ensure that the SSNs of their employees are correct when completing Wage and Tax Statements (Forms W-2).

*In the future, businesses may be able to confirm the accuracy of a TIN by using the Internet to contact the IRS.*

At one time, the IRS had a TIN verification system in place on a pilot basis, but the equipment supporting the system was destroyed by fire and was never replaced. As part of its overall business systems modernization

## Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors

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*The IRS could significantly streamline the backup withholding notice process if businesses were required to contact the IRS web site to verify the accuracy of TINs furnished to them by independent contractors.*

*Civil penalties exist to encourage voluntary compliance by supporting the standards of taxpayer behavior required by law.*

efforts, however, the IRS plans to develop an Internet-based application by October 2002. Once it is developed, payers required to file information returns will have an opportunity to determine whether the income recipient's name and TIN match the SSA (for SSNs) and IRS (for EINs) records prior to filing the information return. However, the IRS has no current plans to provide a complementary way, such as by telephone, of accessing the TIN verification system for those taxpayers who do not have access to the Internet.

In addition to improving the accuracy of information returns reporting non-employee compensation, we believe that the IRS' development of a TIN verification system also represents a major opportunity to expedite and strengthen the backup withholding notification process and protect the government from the loss of tax revenue. By changing the law to *require* businesses to use the TIN verification system at the time they hire an independent contractor, the interactive response from the TIN verification system that a submitted TIN was invalid could provide the IRS' official notification for the business to begin the backup withholding process. This would eliminate the significant lag time that currently exists with the IRS' backup withholding notification process.

### **Civil penalties are not effectively promoting compliance with information reporting requirements for independent contractors**

As previously stated, Treasury Regulation § 301.6721-1 permits the IRS to impose a \$50 civil penalty upon payers for each information return that fails to include all required information or that includes incorrect information. Civil penalties exist to encourage voluntary compliance by supporting the standards of taxpayer behavior required by law, and are effective when they educate taxpayers and enhance their future compliance.

## Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors

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*The IRS assessed penalties against less than one percent of the payers who submitted information returns with missing or invalid TINs.*

The IRS has established an administrative threshold that causes the Incorrect Information Penalty to be rarely proposed or assessed.<sup>19</sup> As a result, the penalty appears to have a negligible impact on encouraging the accurate reporting of TINs on Forms 1099-MISC.

For example, the IRS' data showed that:

- Penalties were assessed against only 3,356 (0.2 percent) of the approximately 1,643,000 payers who filed Forms 1099-MISC for TYs 1996 and 1997<sup>20</sup> with missing or invalid TINs.
- The IRS' administrative criteria for issuing proposed penalty notices potentially identified only 3,100 (0.4 percent) of the 842,177<sup>21</sup> payers who submitted Forms 1099-MISC for TY 1998 with missing or invalid TINs.

Thus, the IRS' administration of the penalty excludes the vast majority of payers whose submissions of Forms 1099-MISC show obvious failures to make good-faith efforts to comply with the backup withholding requirements. For TYs 1996 through 1998, for example, nearly 619,000 payers submitted more than 1,320,000 Forms 1099-MISC with missing TINs or with obviously incorrect TINs.<sup>22</sup> Since none of these payers had implemented backup withholding, it suggests that most payers can fail to comply with the information reporting

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<sup>19</sup> The IRS establishes administrative criteria to focus its available resources on the most productive workload.

<sup>20</sup> At the time of our review, TY 1998 data on penalties was not available.

<sup>21</sup> We excluded 19,432 of the 861,609 TY 1998 payers from this analysis because they either were not required to file Form 1099 or the payer's TIN was not a possible match on the IRS' Payer Masterfile records. Possible matches must have nine digits and cannot contain all nines.

<sup>22</sup> Obviously incorrect TINs would include those reported as zero, less than nine digits, the same nine digits, or as 123456789. The IRS' procedural guidelines refer to some of these as "impossible" TINs.

## **Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors**

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and backup withholding requirements without any financial consequences.

### **Recommendations**

To promote accurate information reporting for non-employee compensation, strengthen the backup withholding and penalty program, and protect against the potential loss of tax revenue, the Director, Compliance, SB/SE Division, should:

2. Explore opportunities to supplement the IRS' future Internet-based TIN confirmation program with an automated telephone-based TIN confirmation process for those payers who do not have Internet access.
3. Initiate a legislative proposal for the IRS Commissioner to submit to Treasury recommending changes to the tax law to make it mandatory for payers to verify the accuracy of TINs with the IRS at the beginning of their relationship with a payee.
4. Change the IRS' administrative guidelines to stipulate that, when the results of any submission to the TIN verification program indicates that the TIN is invalid, it constitutes the IRS' official notice to the payer to begin imposing backup withholding if the recipient does not provide a correct TIN.
5. Initiate a proposal for the IRS Commissioner to submit to Treasury recommending changes to the criteria for asserting the Incorrect Information Penalty. The penalty criteria should be revised to enable the IRS to summarily assess payers for the amount of any backup withholding they failed to collect when required by law. These would include payers who filed information returns with missing TINs and failed to implement backup withholding, and payers who failed to implement backup withholding after the IRS notified them that a submitted TIN was incorrect. A tracking system would likely be needed to identify those payers who should have implemented backup withholding.

## **Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors**

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Management's Response: The Commissioner, SB/SE Division, responded that he will consider the feasibility of supplementing the Internet-based TIN confirmation program with an automated telephone-based TIN confirmation process. However, he did not agree that the IRS should propose legislation making it mandatory for payers to verify the accuracy of TINs at the beginning of their relationship with a payee. He stated he did not agree that such legislation would be effective or that the IRS could administer such a mandate. He also stated that, if such a system were created, it would be cost prohibitive to administer.

The Commissioner, SB/SE Division, did not agree with changing the IRS' administrative guidelines so that, when the results of any submission to the TIN verification program indicates that a TIN is invalid, it constitutes the official notice to the payer to begin imposing backup withholding if the recipient does not provide a correct TIN. He stated that it is cost prohibitive at this time to implement a system to track those payers who are not imposing backup withholding on missing TINs.

The Commissioner, SB/SE Division, will consider proposing legislation to change the criteria for asserting the Incorrect Information Penalty, as well as the amount of penalty that should be applicable for noncompliance. However, he advised that resources have not been identified to fund the design and implementation of a tracking system for those accounts that should have been in backup withholding status.

Office of Audit Comments: Again, we are encouraged that the IRS plans to consider some of our recommendations. However, we are disappointed that the IRS' response does not reflect a stronger overall commitment, or propose alternative solutions, to address a significant tax compliance problem involving a rapidly increasing segment of taxpayers.

We are particularly concerned that the IRS does not plan to enforce accurate TIN reporting once an electronic

## **Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors**

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web-based TIN verification program is made available to payers. Without enforcement, payers could put in any nine digits for a TIN to avoid imposing backup withholding and the IRS would have no more compliance than it does now.

### **Conclusion**

The IRS' limited attempts to apply backup withholding requirements and impose civil penalties after payers have submitted their annual information returns are not effectively promoting compliance by independent contractors or reducing the number of documents received each year with missing or invalid name/TIN data. Significant tax revenues may be lost by the IRS' inability to match information documents with missing or invalid TINs with tax return data.

A tax law change to require payers to withhold taxes from payments to independent contractors offers the best solution for increasing the accuracy of TIN information on Forms 1099-MISC reporting non-employee compensation. Expanding withholding to nonwage earners would also protect the Treasury from the potential loss in revenue resulting from unreported income and unpaid taxes.

A second approach would necessitate changing the law to require payers to verify the accuracy of a TIN at the beginning of their relationship with a new worker. The IRS' planned Internet-based application could be used to make the backup withholding notification process instantaneous when a payee furnishes the payer an incorrect TIN. Stronger penalties are needed for payers who do not impose backup withholding when required by law.



## Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors

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### Appendix I

#### Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether opportunities exist for the Internal Revenue Service (IRS) to increase payer compliance with the information return filing/reporting requirements for non-employee compensation through using the existing laws and regulations. To accomplish this objective, we:

- I. Determined whether the IRS effectively monitored and enforced payer compliance with the Internal Revenue Code (I.R.C.)<sup>1</sup> provisions enacting backup withholding requirements for income recipients who fail to furnish a correct Taxpayer Identification Number (TIN).
  - A. Researched the I.R.C. to determine the conditions under which payers are required to start deducting the backup withholding tax from the income recipient's payment.
  - B. Reviewed the program requirements for the Backup Withholding-Incorrect TIN Program to determine the IRS' administrative criteria for notifying payers about their backup withholding responsibilities.
  - C. Interviewed IRS personnel to determine whether controls had been established to ensure that payers comply with the backup withholding requirements.
  - D. Obtained an Information Returns Masterfile (IRMF) extract of all Statements for Recipients of Miscellaneous Income (Forms 1099-MISC) submitted with invalid taxpayer identification information for Tax Years (TY) 1995 through 1998. Analyzed the 9,634,855 unique records reporting non-employee compensation to determine the:
    1. Average number of documents and the average amount of non-employee compensation reported on Forms 1099-MISC submitted with invalid TIN information.
    2. Potential number of notified payers for TY 1996 that would have had an opportunity to solicit correct TIN information from the worker before filing the subsequent information return.
    3. Average number of distinctively different invalid worker TINs that appeared after TY 1995.

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<sup>1</sup> 26 U.S.C. § 3406 (2000).

## **Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors**

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- 4. Number of payers who did not immediately implement backup withholding when the income recipient did not furnish a TIN.
  - E. Obtained a download of the payer/worker information used to generate all TY 1998 backup withholding notices. Matched the notice data to the TY 1998 IRMF data to determine the number of Form 1099-MISC payers that the IRS' administrative criteria excluded from the post-filing compliance notice process.
- II. Evaluated whether the IRS' application of the information return civil penalty against payers who submitted information documents with missing or incorrect TINs was consistent with its Penalty Policy Statement.
  - A. Reviewed Treasury Regulation § 301.6721-1 for guidelines on imposing the penalty for failure to file correct information returns.
  - B. Reviewed the Internal Revenue Manual Penalty Handbook and the Penalty Policy Statement (P-1-18) to determine the purpose of penalties and the guidelines established for assertion.
  - C. Reviewed the program requirements for the Incorrect Information Penalty Program to determine the IRS' administrative criteria for proposing the penalty.
  - D. Applied the IRS' administrative criteria for issuing proposed penalty notices to the TY 1998 IRMF data to determine the potential number of payers selected for post-filing compliance action.
  - E. Analyzed the IRMF data for TYs 1996 through 1998 to determine the number of payers who submitted documents with either no TIN or with an obviously incorrect TIN.
  - F. Obtained a Masterfile<sup>2</sup> extract of the incorrect TIN penalties assessed for TYs 1996 and 1997<sup>3</sup> to determine the actual number of Form 1099-MISC payers that were assessed a penalty.

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<sup>2</sup> The Masterfile is the IRS' main computer system, containing taxpayer accounts.

<sup>3</sup> At the time of our review, TY 1998 data on penalties was not available.

## **Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors**

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### **Appendix II**

#### **Major Contributors to This Report**

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**Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer  
Identification Numbers for Independent Contractors**

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**Appendix III**

**Report Distribution List**

Commissioner N:C  
Deputy Commissioner, Small Business/Self-Employed Division S  
Director, Compliance, Small Business/Self-Employed Division S:C  
Director of Communications, Small Business/Self-Employed Division S:COM  
Acting Director, Internal/External Stakeholders, Small Business/Self-Employed Division,  
Compliance Policy S:C:CP:I  
Director, Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O  
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Office of Management Controls N:CFO:F:M  
Audit Liaison: Commissioner, Small Business/Self-Employed Division S

## Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors

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### Appendix IV

#### Outcome Measures

##### Type and Value of Outcome Measure:

- Increased Revenue/Revenue Protected – Potential; \$2.2 billion in income taxes collected per year through backup withholding on non-employee compensation payments to independent contractors that fail to furnish a Taxpayer Identification Number (TIN).<sup>1</sup> Over 5 years, \$11 billion (see page 9).

##### Methodology Used to Measure the Reported Benefit:

The potential \$2.2 billion in increased revenue/revenue protected per year was calculated by applying the 31 percent backup withholding rate to the total \$7.2 billion in non-employee compensation payments reported to the Internal Revenue Service on Tax Year 1998 Forms 1099-MISC that did not contain a TIN. These funds represent the tax dollars that approximately 192,000 payers were required by law to withhold from nearly 417,000 independent contractors who did not furnish a TIN.

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<sup>1</sup> An undeterminable portion of the revenues collected through backup withholding may be refunded when tax returns are subsequently filed.

# Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors

Appendix V

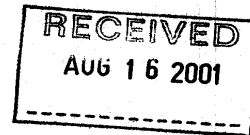
## Management's Response to the Draft Report



COMMISSIONER  
SMALL BUSINESS/Self-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

AUG 16 2001



### MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:

*Joseph G. Kehoe*  
Joseph G. Kehoe

Commissioner, Small Business/Self-Employed Division

SUBJECT:

Draft Audit Report – Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors

I appreciate the opportunity to review and comment on the subject draft audit report. We agree with your overall findings that significant revenue loss does result from TIN inaccuracies. As you noted in your report, the Service is developing an electronic, web based, TIN Matching Program to reduce the number of 1099-MISC's filed without a TIN. This program will enable payers to match up to 25 combinations online per session and up to 100,000 in each batch sent electronically. We expect that the TIN Matching Program will be available to all authorized payers and designees by September 2002.

We also reviewed your proposed outcome measure of increased revenue/revenue protection. The measure focuses on back-up withholding rather than on taxes owed. We suggest that you clarify the definition of the measure to ensure that readers of the report understand that the actual amount owed may be less than \$2.2 billion.

Our specific comments on the recommendations in this report are as follow:

**IDENTITY OF RECOMMENDATION 1:** Initiate a proposal for the IRS Commissioner to submit to Treasury recommending changes to the tax law to require the mandatory withholding of income taxes on non-employee compensation payments.

**ASSESSMENT OF CAUSE:** IRS has previously submitted proposals for legislative changes to Treasury that would require mandatory withholding of income taxes on non-employee compensation payments. In the past, Treasury has chosen not to forward these proposals to Congress.

**CORRECTIVE ACTION:** We will work with our Legislative Affairs Office to consider the likelihood of Treasury's acceptance of a resubmitted proposed legislative change.

**IMPLEMENTATION DATE:** By 12/31/2001 we will decide whether it is feasible to submit additional proposed legislative changes.

## Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors

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RESPONSIBLE OFFICIAL: Commissioner, SB/SE

CORRECTIVE ACTION MONITORING PLAN: None

**IDENTITY OF RECOMMENDATION 2:** Explore opportunities to supplement the IRS' future Internet-based TIN confirmation program with an automated telephone-based TIN confirmation process for those payers who do not have Internet access.

ASSESSMENT OF CAUSE: It is anticipated that the large majority of payers would have access to the Internet. However, it makes good business sense to provide a system that can be accessed by the most payers.

CORRECTIVE ACTION: We will consider the feasibility of the above proposal. There are alternative locations where payers might get access to the Internet, such as public libraries. Also there may be existing systems that we may be able to use to support this proposal.

IMPLEMENTATION DATE: By 06/30/02 we will consider the use of other systems.

RESPONSIBLE OFFICIAL: Commissioner, SB/SE

CORRECTIVE ACTION MONITORING PLAN: None

**IDENTITY OF RECOMMENDATION 3:** Initiate a legislative proposal for the IRS Commissioner to submit to Treasury recommending changes to the tax law to make it mandatory for payers to verify the accuracy of TINs with the IRS at the beginning of their relationship with a payee.

ASSESSMENT OF CAUSE: Currently, legislation to require this action is not in place.

CORRECTIVE ACTION: We do not agree that such legislation would be effective or that we could administer such a mandate. If such a system were created, it would be cost prohibitive to administer.

IMPLEMENTATION DATE: None

RESPONSIBLE OFFICIAL: Commissioner, SB/SE

CORRECTIVE ACTION MONITORING PLAN: None

**IDENTITY OF RECOMMENDATION 4:** Change the IRS' administrative guidelines to stipulate that, when the results of any submission to the TIN verification program indicates that the TIN is invalid, it constitutes the IRS' official notice to the payer to begin imposing backup withholding if the recipient does not provide a correct TIN.

ASSESSMENT OF CAUSE: Existing systems do not track the payers who are or are

## Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors

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not in compliance with the existing laws.

**CORRECTIVE ACTION:** The BWH Program for missing TINs as currently administered requires immediate backup withholding on missing or obviously bad TINs (i.e. 123456789, 12345678A). BWH notices are generated for missing TINs, however, as the law is written, the payer does not have to wait for a notice to begin backup withholding on such accounts. The payer is expected to begin backup withholding immediately on those accounts. The BWH Program for incorrect/Name/TIN mismatch information does not require the imposition of backup withholding after the first notice if the payee submits a W-9 to the payer with the same Name/TIN information identified as erroneous. The second notice within a three-year calendar period requires TIN certification either with the Social Security Administration for a SSN or the IRS for an EIN, before backup withholding can be imposed. Implementation of a backup withholding reconciliation process for monies deposited into the BWH Trust Fund could track those payers who are not imposing backup withholding on missing TINs; however, the implementation of such a system is cost-prohibitive at this time.

**IMPLEMENTATION DATE:** None

**RESPONSIBLE OFFICIAL:** Commissioner, SB/SE

**CORRECTIVE ACTION MONITORING PLAN:** None

**IDENTITY OF RECOMMENDATION 5:** Initiate a proposal for the IRS Commissioner to submit to Treasury recommending changes to the criteria for asserting the Incorrect Information Penalty.

**ASSESSMENT OF CAUSE:** A tracking system that would enable this recommendation does not currently exist.

**CORRECTIVE ACTION:** We will consider the above proposal, as well as the amount of penalty that should be applicable for non-compliance. However, the implementation of a tracking system to identify those accounts that should have been in Backup Withholding status must be designed and implemented, and resources devoted to this additional work. Resources have not been identified to fund this activity in the current or subsequent fiscal years.

**IMPLEMENTATION DATE:** By 06/30/02 we will assess the feasibility of implementing this proposal.

**RESPONSIBLE OFFICIAL:** Commissioner, SB/SE

**CORRECTIVE ACTION MONITORING PLAN:** None

If you wish to discuss our response to your draft report, please call Martha Sullivan, Deputy Director, Compliance Policy, Small Business/Self-Employed, at (202) 622-5563.